No. 11745.

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

GEORGE T. GOGGIN, Trustee in Bankruptcy of the Estate of David Ciphers Dudley, doing business as Dave Dudley and Hollywood Leather Goods Mfg. Co., Bankrupt,

Appellant,

vs.

DAVID CIPHERS DUDLEY, doing business as Dave Dudley and Hollywood Leather Goods Mfg. Co., Bankrupt,

Appellee.

OPENING BRIEF OF APPELLANT.

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TOPICAL INDEX

TABLE OF AUTHORITIES CITED

Cases

Statutes

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OPENING BRIEF OF APPELLANT.

Statement of Jurisdiction.

The jurisdiction of the United States District Court in the voluntary proceeding of the bankrupt was invoked under the provisions of Section 2-a, Subdivision 1, of the National Bankruptcy Act and amendments thereto (11 U. S. C. A., Sec. 11, Subdivision 1).

Jurisdiction of the District Court on review was invoked under the provisions of Section 2-a, Subdivision 10 of the National Bankruptcy Act (11 U. S. C. A., Sec. 11, Subdivision 10). The jurisdiction of the Referee to determine the claim of the bankrupt to his exemptions was invoked under the provisions of Section 2-a, Subdivi-

sion 11 (11 U. S. C. A., Sub-section 11). The jurisdiction of this court on appeal was invoked under the provisions of Section 24-a of the National Bankruptcy Act (11 U. S. C. A., Sec. 48-a).

Opinion Below.

The Opinion of the Referee in Bankruptcy is found at Transcript, page 41. His Findings of Fact and Conclusions of Law amplifying this Opinion are found at Transcript, pages 42 to 44. The Opinion of the District Judge on Petition for Review is found at Transcript, pages 49 to 60, inclusive.

Statutes Involved.

Bankruptcy Act, Section 6 (11 U. S. C. A., Sec. 24). Code of Civil Procedure of California, Secs. 690 and 690.21. Bankruptcy Act, Sec. 67-d-2, Subdivision d (11 U. S. C. A., Sec. 107-d-2-d). Bankruptcy Act, Sec. 70-a, Subdivisions 4 and 5 (11 U. S. C. A., Sec. 110-a, Subdivisions 4 and 5).

Points Upon Which Appellant Intends to Rely.

The points upon which the appellants intend to rely are closely related and follow:

Point 1: That the District Court erred in reversing the Order of the Referee declining to sustain the Objections to the Trustee's Return of Exempt Property, and approving the same.

Point 2: That the District Court erred in not affirming and adopting the Referee's Findings of Fact, Conclusions of Law and Order *re* Exempt Property dated March 21, 1947.

Point 3: That the District Court erred in making an Order directing that an Order be made by the Referee setting apart the Building & Loan stock of the value of $1,000.00 claimed by the bankrupt as exempt.

Point 4: That the District Court erred in holding that an insolvent bankrupt within a few days prior to the filing of his petition, and while insolvent and at a time when his petition in bankruptcy is being prepared, and while in contemplation of bankruptcy, has a right as against creditors to convert non-exempt assets into assets which are exempt when such conversion is made in bad faith and with the corrupt design and intent on the part of the bankrupt to cheat and defraud his creditors.

Statement of the Case.

The bankrupt, David Ciphers Dudley, was a manufacturer of leather goods in Hollywood, County of Los Angeles and State of California [Tr. p. 2]. He filed his voluntary petition in the District Court of the United States for the Southern District of California praying to be adjudged a bankrupt. The petition was verified on January 10, 1947 [Tr. p. 21] and was filed on January 11, 1947. The bankrupt's liabilities taken at his own figures totaled $38,372.49 and his assets taken at his own valuation amounted to the sum of $30,082.13, including property claimed by him as exempt [Tr. pp. 4 and 5]. Among the liabilities it is interesting to note are included large tax claims for excise taxes, withholding taxes and so forth, due the United States Government in the sum of $8,043.48, taxes due State of California amounting to $835.24, and the City of Los Angeles, $20,082.00. The bankrupt also owed wage claims to employees totaling $839.65 [Tr. pp. 5, 6 and 7].

Preparing to go through bankruptcy the bankrupt discovered that he had a little over $1,000.00 in cash on hand. We note that he schedules only $40.00 cash on hand in his bankruptcy schedules [Tr. p. 22]. While his schedules in bankruptcy were being prepared the bankrupt, learning that shares in building and loan associations in the State of California were exempt from execution and attachment under the provisions of Section 690.21 of the Code of Civil Procedure of California, and that there was no provision in the exemption laws of California whereby the cash which he had on hand (probably the sum of $1,540.00) could be exempted to him and withheld from his creditors and taxing bodies, purchased $1,000.00 worth of building and loan stock, scheduled it in his schedules [Tr. p. 28], paid his attorney's fees in the sum of $500.00 and claimed the building and loan stock as exempt.

At the first meeting of creditors he was examined regarding these transactions and the facts brought out. The trustee declined to set aside the building and loan stock as exempt and objections were filed to the trustee's report of exempt property [Tr. pp. 39 and 40].

A hearing was had thereon and at the time of the hearing it was stipulated between the attorneys for the bankrupt and the attorneys for the trustee that the testimony taken at the examination of the bankrupt previously held could be considered by the Referee in determining the issues. The matter was submitted on the testimony adduced at the prior hearing and the Referee, who had

had an opportunity to study the bankrupt at first hand, to judge his attitude and demeanor on the stand and the honesty or bad faith of his intentions in converting this non-exempt cash into building and loan stock, held that the bankrupt had not acted in good faith but with fraudulent intent and sustained the trustee in refusing to set aside this building and loan stock as exempt, in view of all of the circumstances surrouding its acquisition [See Referee's Certificate on Review, Tr. pp. 36 to 38]. The bankrupt filed his petition for review with the District Judge and the matter went up on review based on the Referee's Certificate, his Memorandum Opinion and Findings of Fact and Conclusions of Law. The testimony which had been adduced at the previous examination of the bankrupt was not written up and was not before the District Court. The only record before the District Judge was based on the Referee's statement of evidence and his Findings of Fact, Conclusions of Law and Order. In the face of the Referee's express finding that the bankrupt had acted in bad faith in acquiring these shares of building and loan stock while his petition in bankruptcy was being prepared, and that he had a corrupt design and intent to cheat and defraud his creditors [See Referee's Findings of Fact, Tr. p. 43], the District Judge reversed the Order of the Referee and entered an Order directing that the building and loan stock be set aside as exempt and rendered judgment accordingly [See Tr. pp. 60 to 62].

The trustee has appealed from the Order and Judgment of the District Court reversing the Referee's Order.

ARGUMENT, POINTS AND AUTHORITIES.

The District Court Erred in Reversing the Order of the Referee Declining to Sustain the Objections to the Trustee's Return of Exempt Property and Approving the Same.

The District Court Erred in Not Affirming and Adopting the Referee's Findings of Fact, Conclusions of Law and Order Re Exempt Property Dated March 21, 1947.

In discussing the above errors we wish to point out to the court that there was no transcript of testimony taken to the District Court on the review and the review was predicated on the statement of evidence and Referee's Certificate. As heretofore pointed out, a Stipulation was entered into at the time of the hearing on the trustee's return of exempt property; that the Referee could take into consideration the testimony adduced at a prior examination of the bankrupt where the Referee had had an opportunity to see the bankrupt face to face and to consider his attitude and demeanor. The findings of the Referee were based on this examination which was not before the District Judge and the reversal was based on a cold record. The Referee was satisfied from the bankrupt's attitude that his acquisition of this building and loan stock was actually fraudulent and that more was here than a mere belated protection of a home which the bankrupt was already occupying with his family.

The authorities are conflicting on the question of whether or not the conversion of non-exempt assets into exemptions shortly prior to bankruptcy constitutes a transfer with intent to hinder, delay or defraud creditors,

but it will be noted that the decisions in favor of the exemption are qualified where the conversion is not made in bad faith. In the case at bar the Referee found that the bankrupt had acted in bad faith in converting this non-exempt cash into exempt building and loan securities, and we submit that that finding takes this case out of the qualification of the authorities favorable to the exemption.

In *Kangas v. Robie,* 264 Fed. 92, the United States Circuit Court of Appeals for the Eighth Circuit, said:

> "The situation which petitioner presents to us is a confession of bad faith on his part, that the purpose with which he took title to the property which he now claims as exempt was to defraud his creditors, and we must decline to give it our approval. We are persuaded that the Supreme Court of Minnesota would also refuse to approve such conduct and make it a basis on which to allow the exemption. That court, in Esty v. Cummings, 78 N. W. 242, 244, has expressed itself in this language:
>
> " 'While the homestead right is a valuable one, and the protecting arm of the law should be carefully used in guarding it, it was never intended, and it should never be permitted, to operate as a vehicle for fraud and rank injustice.' See also Small v. Anderson, 139 Minn. 292, 166 N. W. 340.
>
> "This is in accord with what we held in Huenergardt v. Dry Goods Co., 116 Fed. 31 and Amundson v. Folsom, 219 Fed. 122. The Court of Bankruptcy did not err in matter of law. The petition must be dismissed at petitioner's cost."

In the Matter of Gerber, 186 Fed. 693, 26 A. B. R. 608, this Court speaking through Judge Ross, said:

> "While it is well-established law that exemptions in behalf of unfortunate debtors are to be liberally construed in furtherance of the object of such statutes, it should never be forgotten that courts have not the power to legislate, and can no more add an exemption not fairly within the statute than they can take from the statute. So also must it be remembered that courts of bankruptcy proceed upon equitable principles, and should no more sustain a positive fraud than would a court of equity. In respect to this homestead claim, both the referee and the District Court expressly recognized its fraudulent character. In view of the facts found, it is impossible to see how it could have been otherwise. Here was a debtor fully conscious of his bankruptcy, strenuously opposing those of his creditors who were seeking his adjudication as a bankrupt, the while disposing of and secreting his cash, and finally consenting to such an adjudication provided the creditors would dismiss their then pending petition for his adjudication as a bankrupt and procure other creditors to file a new one; his obvious purpose, made manifest by his action, being to put, in the interim, the money to which his creditors were justly entitled into property upon which he could and did forthwith declare a homestead. Surely no court acting upon equitable principles should sustain such a transaction."

In the Matter of Levinson, 295 Fed. 736, 1A. B. R. (N. S.) 496, the District Court speaking through the

late Judge William P. James in overruling the contention of a bankrupt seeking to exempt certain policies of insurance purchased by him on the eve of bankruptcy, said:

> "It may be said that it appears beyond even a reasonable doubt that all of the money which went to pay insurance premiums was property of the bankrupt's estate and was property which the trustee had the right to demand and receive possession of. It cannot be said that the policy of insurance may be saved to the bankrupt under the specious claim of exemption, for the best conclusion that can be made from the testimony is that the taking out of the insurance and the filing of the petition in bankruptcy was approximately of the same time."

In the Matter of Majors, 241 Fed. 538, 39 A. B. R. 642, the District Court for the District of Oregon said:

> "The local statute relating to exemptions does not, as is the case in other States, grant exemption in money in lieu of property, but only in property in kind. Section 227, Lord's Oregon Laws. The attempt, therefore, to avail himself of the statute by converting the money into exempt property in anticipation of bankruptcy was a fraud upon the creditors, and it has been so held in this circuit in a case of strong analogy to this. Freedman Bros. Co. v. Parker (C. C. A. 9th, Cir.), 186 Fed. 693. (Citing McGahan v. Anderson from the Fourth Circuit, 113 Fed. 115, 119.) I am, of course, bound by this authority, which has the further merit of being sound upon principle. It follows that the bankrupt cannot legitimately claim this property as exempt."

In *Amundson v. Folsom,* 219 Fed. 122, 33 A. B. R. 318, the Circuit Court of Appeals for the Eighth Circuit, said:

> "It is too narrow a view to regard each step in the transaction separately and independently. It may be true as argued that creditors of a partnership merely as such have not a lien on partnership assets as distinguished from an equity in their administration, or that the members of an insolvent firm may lawfully sever their relation and one sell his interest in the firm property to the other, or that a debtor in failing circumstances can turn business assets into exempt property and hold it, or that one may lawfully purchase a stock of goods in bulk from another, or, finally, that it is not in itself fraudulent for an insolvent debtor merely to make a preferential transfer or for his creditor to receive it. But all such things, especially when in close consecutive association, are to be considered with what else appears in determining whether the result was the consummation of a preconceived purpose to hinder, delay or defraud creditors. * * * Transactions apparently innocent when separately regarded may take on a different signification when seen in their true connection with others. And it is not always safe to venture a prohibited course on a mosaic of sound but unrelated rules of law."

In *McGahan v. Anderson* (C. C. A. 4th Cir.), 113 Fed. 115, 7 A. B. R. 641, the Circuit Court of Appeals for the Fourth Circuit disallowed a homestead exemption to a bankrupt who had withdrawn money from his business and invested it in a homestead, using the following language:

> "The fair deduction from all the evidence in this case tends clearly to prove that at the time he com-

menced the erection of this house he was in a failing condition, if not insolvent. He built this house upon a lot owned by his wife, and afterwards had it conveyed to himself in order that he might have it set apart as a homestead. This is a most potential fact to show that he was shaping his course to protect himself as far as possible from the consequence of bankruptcy, which the evidence tends to show was imminent at that time, for on the 25th day of October following a petition of involuntary bankruptcy was filed against him, and in less than a month he was adjudicated a bankrupt. We deem it unnecessary to discuss the evidence in detail filed in this case, but content ourselves with the conclusions that we have reached based upon all the evidence, more particularly on the evidence of the bankrupt himself."

In the Matter of Boston, 98 Fed. 587, 3 A. B. R. 388, the United States District Court for the District of Nebraska affirmed an Order of the Referee disapproving the conversion of non-exempt property and applying the proceeds thereof on an encumbrance upon property which was exempt without Opinion.

In *Laderburg, Bankrupt, v. Miller, Trustee,* 210 Fed. 614, 31 A. B. R. 335, the Circuit Court of Appeals for the Fourth Circuit in a case where a bankrupt who was in business separated from his stock numerous articles of merchandise valued at $867.90, together with store fixtures valued at $145.00 and claimed them exempt under a Virginia Statute which permitted the setting aside of

a homestead in personal property as exempt, using the following language:

> "It follows that the debtor cannot by his act of closing his store or separating a part of his shifting stock of merchandise with the view of defeating the rights of the creditor have a homestead in such property. To hold that the Constitution contemplates that such a result could be secured by such a method, would be to make of no effect the constitutional provision that a shifting stock of goods shall not be exempt. * * * Under this rule the Constitution of Virginia cannot be construed to contemplate the annulment of one of its own provisions by allowing a failing debtor to transmute a shifting stock of merchandise not exempt into exempt property by withdrawing it from sale for the purpose of claiming it as an exemption."

In the lower courts in the case at bar the bankrupt relied heavily on *Forsberg v. Security State Bank of Canova,* 15 Fed. (2d) 499, 8 A. B. R. (N. S.) 794. This case, however, is quite distinguishable from the case at bar. In the first place it was a review of an order denying a bankrupt his discharge on the ground that within four months preceding the filing of this petition he had transferred property consisting of horses, cattle and hogs with the intent to hinder, delay and defraud his creditors, using the proceeds of the sale of the property to purchase certain sheep and other personal property which he later claimed exempt under the Statutes of South Da-

kota. The Referee, sitting Special Master, expressly found at the trial that the transfer was not made with intent to hinder or delay his creditors, and that the objections filed by the objecting creditor had not been sustained. The District Judge overruled the Findings of the Referee and denied the bankrupt his discharge. The Circuit Court of Appeals for the Eighth Circuit reversed the District Judge and ordered the bankrupt discharged. In discussing the case of *Kangas v. Robie,* 264 Fed. 92, cited by the objecting creditor, the Circuit Court of Appeals pointed out that Kangas, the bankrupt, in that case, had ceased making payments on his trade obligations, ceased making daily deposits in the bank until he accumulated $13,000.00, invested the same in an apartment building and claimed the building exempt as a homestead. In discussing the *Kangas* case the Circuit Court of Appeals said:

> "The referee in bankruptcy denied the claimed exemption. He found that there was a fraudulent attempt on the part of Kangas to put the money realized from the collection of his accounts and the sale of merchandise beyond the reach of creditors from whom he received said merchandise on credit. The District Judge found that Kangas 'set out with the corrupt purpose and design of defrauding his creditors; * * * that he made the purchase, moved into the property, and is now claiming it as a homestead to accomplish that purpose and design.' The action of the referee was approved."

Conclusion.

As we have heretofore pointed out, the line of reasoning in the cases holding contrary to the case at bar were cases wherein the Referee as a trier of fact had not found actual fraud on the part of the bankrupt. In the case at bar the Referee found that the bankrupt had acted toward his creditors in bad faith and with a corrupt intent. We submit that the Referee after having heard the bankrupt's testimony directly at his examination, which was stipulated could be considered as the evidence in this case, was in a much better position to judge from the bankrupt's attitude what his intent was than was the District Judge on review, particularly where the testimony of the bankrupt at his previous examination had not been written up, was not certified to the District Court, and the reversal therefore predicated on the Referee's Findings. The exemption laws of California, it is true, are very liberal, but we do not believe it was the intent of the Legislature to permit a debtor to walk off with property worth $15,000.00 or $20,000.00 and at the same time permit him to discharge his obligations after manipulating his non-exempt assets as was done here. The Exemption Statutes of California are included in twenty-four subsections of Section 690 of the Code of Civil Procedure. Some of the subsections are limited as to value, for instance, tables, chairs and so forth, maximum, $200.00, Section 690.1; farming equipment and draft animals, $1,000.00 and $200.00 respectively, Section 690.3; poultry valued at $75.00, Section 690.9; one-half

or all of his earnings within thirty days preceding the levy, dependent on whether or not the debt was incurred for common necessities of life, Section 690.11; stock in building and loan associations of a value of $1,000.00, Section 690.21. The above personal property exemptions are in addition to the $7,500.00 homestead now allowed under the laws of the State of California.

The Bankruptcy Court operates on the equity side. We do not believe that a court of equity should countenance a business man or manufacturer, as is the case with this bankrupt, taking money out of his business and investing it in securities on the eve of bankruptcy while his schedules are being prepared and being permitted to claim it as exempt, especially in the face of the Referee's finding of bad faith on the part of the bankrupt.

In considering the holding of the Circuit Court of Appeals for the Eighth Circuit in *Forsberg v. Security State Bank of Canova,* 15 F. (2d) 499, please bear in mind that in that case the bankrupt was faced with a penal statute, Section 14 of the National Bankruptcy Act, which provided for a denial of his discharge if within four months preceding the filing of the petition he had transferred property with the intent and purpose on his part to hinder, delay or defraud his creditors. If the Court sustained the Trustee's contention in that case the bankrupt would have completely forfeited his discharge in so far as all of his debts were concerned. We have no such situation here. Here the Referee merely told the bankrupt that the Bankruptcy Court would not aid him in

permitting him to convert his non-exempt cash into exempt assets by setting the exempt assets aside to him in bankruptcy proceedings. In the *Forsberg* case the bankrupt would have forever lost his discharge as to all of his debts. In the case at bar this bankrupt will have lost nothing. He has merely been told that he cannot affirmatively enrich himself unjustly to the extent of $1,000.00 where, barring the transmutation of his cash into building and loan stock, the $1,000.00 would have gone to his creditors. We believe with the late Judge Ross of this Circuit, author of the Opinion *In the Matter of Gerber,* 186 Fed. 693, that Courts of bankruptcy, proceeding upon equitable principles, should no more sustain a positive fraud than would a court of equity.

We respectfully submit that the order and judgment of the District Judge should be reversed and that of Referee Dickson affirmed.

Respectfully submitted,

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